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BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS

GARY PIERCE, Chairman
BOB STUMP
SANDRA D. KENNEDY
PAUL NEWMAN
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AZ CORP COMMISSION
DOCKET CONTROL

Arizona Corporation Commission

DOCKETED

JAN 18 2012

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IN THE MATTER OF THE APPLICATION OF
ARIZONA PUBLIC SERVICE COMPANY FOR A
HEARING TO DETERMINE THE FAIR VALUE OF
THE UTILITY PROPERTY OF THE COMPANY
FOR RATEMAKING PURPOSES, TO FIX A JUST
AND REASONABLE RATE OF RETURN
THEREON, TO APPROVE RATE SCHEDULES
DESIGNED TO DEVELOP SUCH RETURN.

Docket No. E-01345A-11-0224

**NOTICE OF FILING
TESTIMONY IN SUPPORT OF
SETTLEMENT AGREEMENT**

Pursuant to the requirements of the December 23, 2011 Procedural Order, on behalf of
the Arizona Investment Council ("AIC"), attached are the following testimonies in support of the
settlement agreement:

1. The Testimony of AIC President, Gary Yaquinto; and
2. The Testimony of Steven M. Fetter.

RESPECTFULLY SUBMITTED this 18th day of January, 2012.

GALLAGHER & KENNEDY, P.A.

By

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BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS

GARY PIERCE, Chairman
BOB STUMP
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IN THE MATTER OF THE APPLICATION OF
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DESIGNED TO DEVELOP SUCH RETURN.

Docket No. E-01345A-11-0224

Testimony of

Gary M. Yaquinto

in Support of Settlement Agreement

on Behalf of

Arizona Investment Council

January 18, 2012

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1 **1. INTRODUCTION**

2 **Q. Please state your name, position and business address.**

3 A. Gary M. Yaquinto. I am the President of the Arizona Investment Council
4 ("AIC"). Our offices are located at 2100 North Central Avenue, Phoenix,
5 Arizona 85004.

6
7 **Q. Have you filed testimony previously in this proceeding?**

8 A. Yes, I filed direct testimony on November 18, 2011.

9
10 **Q. What is the purpose of this testimony?**

11 A. My testimony is offered to explain AIC's support for the Proposed Settlement
12 Agreement filed by Staff on January 6, 2012 ("Settlement Agreement").

13
14 **2. SETTLEMENT AGREEMENT**

15 **Q. Is AIC a signatory to the Settlement Agreement?**

16 A. Yes. We participated with the other signatories in the discussion and negotiations
17 which led to the execution of the Settlement Agreement by almost all intervenors
18 in the case. We also participated in the meetings arranged by APS to discuss
19 technical aspects of the Company's filing. All meetings convened to discuss the
20 application and to negotiate the Settlement Agreement were transparent and open
21 to all intervenors.

22

23

1 **Q. Generally, why does AIC support the Settlement Agreement?**

2 A. AIC supports the Settlement Agreement because it contains provisions that are
3 fair to and benefit APS, its customers, its investors and the public in general.
4

5 Specifically, the Settlement Agreement builds on the progress established in APS'
6 last case by improving the Company's financial condition so it can compete in
7 attracting capital for investments to meet the needs of its customers. By keeping
8 the base rate essentially at an even level and then incorporating an opportunity to
9 gradually adjust rates for some cost increases during the four-year moratorium
10 period, customers will enjoy substantial rate stability and the potential for future
11 rate shock is minimized.
12

13 The benefits to investors include greater certainty and the potential for lower
14 earnings attrition than would otherwise occur during the four-year moratorium.

15 Other provisions in the Settlement Agreement that are of particular importance to
16 AIC are:

- 17 - Changes in the Fuel Power Supply Adjustor to remove the 90/10 sharing
18 provision;
- 19 - A possible rate adjustment for APS' acquisition of Southern California
20 Edison's share of Four Corners Units 4 and 5, if approved by the
21 Commission;
22
23

- A modification to the Environmental Improvement Charge by resetting it to zero and enabling APS to recover on a more timely basis some of the carrying costs of its investments in government-mandated environmental controls; and
- A cost deferral related to near-term changes in Arizona property tax rates.

Also, as AIC expert witness Steve Fetter states in his testimony, the Settlement Agreement, if approved by the Commission, will likely be viewed favorably by rating agencies as they consider possible revisions to APS' bond ratings. This should afford the Company better access to capital at more attractive rates.

Q. What is AIC's view of the Lost Fixed Cost Recovery ("LFCR") mechanism included in the Settlement Agreement?

A. Inclusion of the LFCR mechanism – which will enable the Company to recover lost fixed cost revenue due to mandated reductions in sales primarily attributable to energy efficiency programs – was an essential component of the Settlement Agreement from AIC's standpoint. While the LFCR differs from our preferred methodology of full revenue decoupling, it nevertheless is an acceptable approach under the circumstances of this case and one supported by all signatories. In addition to enabling the Company to recover some lost fixed cost revenue, it provides customers the assurance that adjustments will be capped at one percent,

1 as well as the opportunity to opt out of the LFCR and elect an alternative rate
2 structure instead.

3
4 **Q. Are there any other reasons for AIC's support of the Settlement Agreement?**

5 A. Yes. The Settlement Agreement responds to the Commission's expressed desire
6 to maintain flexibility as it considers such agreements in connection with rate
7 cases. AIC continues to believe that settlement agreements provide opportunities
8 for creative solutions among parties that otherwise would not be available through
9 litigated proceedings. Settlements like the one reached in this case also help
10 streamline the regulatory process and lower costs to all parties, which improves
11 the overall regulatory environment.

12
13 Finally, as discussed in my direct testimony, APS is Arizona's largest electric
14 utility and a major contributor to our State's economy. Approval of the
15 Settlement Agreement will support APS' continued financial health – that has a
16 positive, reverberating impact throughout Arizona in the form of jobs, taxes and
17 income.

1 **3. RECOMMENDATION**

2 **Q. Mr. Yaquinto, what is AIC's recommendation for the Commission in relation**
3 **to the Settlement Agreement?**

4 A. The Settlement Agreement represents an appropriate, productive balance among
5 the often widely divergent views of the parties on a broad and challenging set of
6 issues. In reaching that accord, the process was open and transparent and the
7 result reflects give and take on the part of all participants. It builds on progress
8 from the last rate case and should give the Company a realistic opportunity to
9 recover its prudent costs and earn a reasonable rate of return over the next four
10 years. We recommend the Commission enter its Order approving the Settlement
11 Agreement.

12

13 **Q. Does that conclude your testimony?**

14 A. Yes, it does.

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BEFORE THE ARIZONA CORPORATION COMMISSION

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Docket No. E-01345A-11-0224

Testimony of

Steven M. Fetter

in Support of Settlement Agreement

on Behalf of

Arizona Investment Council

January 18, 2012

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INTRODUCTION 1

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1 **INTRODUCTION**

2 **Q. PLEASE STATE YOUR NAME, POSITION AND BUSINESS ADDRESS.**

3 A. My name is Steven M. Fetter. I am President of Regulation UnFettered. My
4 business address is P.O. Box 280, Nordland, Washington 98358.

5
6 **Q. PLEASE BRIEFLY SUMMARIZE YOUR EMPLOYMENT**
7 **EXPERIENCE.**

8 A. As mentioned, I am currently the President of Regulation UnFettered, a utility
9 advisory firm I started in April 2002. Prior to that, I was employed by Fitch, Inc.,
10 a credit rating agency based in New York and London. Before that, I served as
11 Chairman of the Michigan Public Service Commission ("Michigan PSC").

12
13 **Q. DID YOU PREVIOUSLY FILE TESTIMONY IN THIS DOCKET**
14 **BEFORE THE ARIZONA CORPORATION COMMISSION**
15 **("COMMISSION" OR "ACC")?**

16 A. Yes. I filed direct testimony on behalf of the Arizona Investment Council on
17 November 18, 2011.

1 **Q. WHAT IS THE PURPOSE OF YOUR SETTLEMENT TESTIMONY?**

2 A. Based upon my experience as a state utility regulator, bond rater, and consultant
3 for regulated utilities, public utility commissions, and consumer advocates, I will
4 focus on the following two issues:

5 a) the positive nature of a rate case being resolved through settlement by the
6 contesting parties, followed by regulatory review and approval; and

7 b) the balanced nature of the terms within the Proposed Settlement
8 Agreement filed in this docket on January 6, 2012 ("Settlement
9 Agreement"), which has been signed by a very diverse group of 22 parties
10 to this case.

11
12 **SETTLEMENT AGREEMENT**

13 **Q. DO YOU HAVE ANY GENERAL OBSERVATIONS ABOUT THE**
14 **SETTLEMENT AGREEMENT?**

15 A. Yes. I find it a thoughtful and creative package of provisions that: (1) are well-
16 balanced across a disparate group of interests, (2) are likely to be well-received by
17 the investment community and rating agencies in continuing to move APS away
18 from the junk status precipice it was poised upon only a few years ago, and
19 (3) afford the Commission considerable flexibility in fashioning energy policies.

1 **Q. PLEASE EXPAND ON YOUR STATEMENT ABOUT THE POSITIVE**
2 **NATURE OF RATE CASES BEING RESOLVED THROUGH**
3 **SETTLEMENT BY CONTESTING PARTIES.**

4 A. During my tenure as Chairman of the Michigan PSC, my fellow commissioners
5 and I always sought to strike a fair balance between competing policy positions in
6 a contested rate case record in a way that furthered the public interest of the State
7 of Michigan. But, what we could not do with certainty in that contested case
8 context was determine the values that each contesting party placed upon each
9 component of the positions argued. It was only through a proceeding on a
10 proposed settlement agreement like this one that we, as regulators, could see the
11 manner in which those parties had struck a fair balancing of their competing
12 positions. The parties' resolution of individual contested issues removed, for the
13 moment, our need to prioritize or make value determinations on those issues.
14 That left us a greater opportunity to evaluate the most important issue – whether
15 the terms of the agreement as a whole were consistent with the public interest.
16 Accordingly, in my role as chairman, I encouraged the Michigan PSC staff to
17 facilitate settlement among competing parties in order to achieve the substantive
18 and procedural benefits that can result from a contested case being concluded by
19 expeditious settlement.

1 **Q. BASED UPON YOUR LONG AND DIVERSE EXPERIENCE WITHIN**
2 **THE UTILITY SECTOR, DO YOU SEE A FAIR BALANCING OF**
3 **COMPETING UTILITY AND CONSUMER INTERESTS WITHIN THE**
4 **SETTLEMENT AGREEMENT?**

5 A. Yes, I do.
6

7 **Q. PLEASE EXPLAIN.**

8 A. First, let me focus on the key consumer benefits of the Settlement Agreement – all
9 of which I view as very positive and significant provisions:

10 a) It is quite rare when a rate case concludes with a zero or negative base rate
11 and bill impact result. Not only does the Settlement Agreement here
12 produce that unusual result (§§ 3.1 and 4.1), it also provides that rates will
13 not rise for any reason during all of 2012 (such as through the operation of
14 adjustment mechanisms) (§ 4.3). Moreover, the agreement also includes a
15 four-year rate case filing stay-out, ensuring that APS' base rates will not
16 go up prior to July 1, 2016 (§ 2.1);

17 b) The Settlement Agreement terms also subject APS, at its own expense, to
18 periodic audits to “incent prudent fuel and power procurement and use”
19 (§ 7.4). Similarly, the Company has agreed to pay for an independent
20 evaluation of its demand-side management programs and associated
21 energy savings, at the sooner of either its next rate case or the passage of
22 five years after a final order in this case (§ 9.14(e));
23

- 1 c) The Settlement Agreement commits APS to interact with stakeholders on
2 issues related to “bill presentation with a goal of making the bill easier for
3 customers to understand” (§ 16.1); and
4 d) A process is also established through which APS, Staff and stakeholders
5 will interact with the aim of developing and filing for ACC consideration
6 “a new performance incentive structure by December 31, 2012 that
7 optimizes the connection between energy efficiency, rates and utility
8 business incentives and that creates a clear connection between the level
9 of performance incentive and the achievement of cost-effective energy
10 savings” (§ 9.14(d)). The goal of that process is to seek to ensure a fair
11 balance between any incentives earned by APS and the consumer benefits
12 produced by the programs.

13
14 **Q. DO YOU BELIEVE THOSE CONSUMER-FOCUSED PROVISIONS ARE**
15 **BALANCED WHEN VIEWED IN THE CONTEXT OF THE BENEFITS**
16 **THAT THE COMPANY WILL RECEIVE?**

17 A. Yes, I do. In that regard, let me review certain Settlement Agreement provisions
18 that are beneficial for APS, which the rating agencies and financial markets will
19 view as positive for the Company’s credit profile:

- 20 a) Section IX of the Settlement Agreement proposes a Lost Fixed Cost
21 Recovery (“LFCR”) mechanism to provide revenue support for load lost
22 as a result of the Company’s energy efficiency (“EE”) and distributed
23

1 generation (“DG”) activities which are being undertaken consistent with
2 Commission directives. While the financial community would prefer a
3 full decoupling policy – one that would allow fixed cost recovery for a
4 broader set of load loss factors – I am confident the LFCR will be viewed
5 as a constructive step in encouraging APS to move forward successfully in
6 implementing EE and DG initiatives, while minimizing the negative
7 financial consequences associated with such efforts;

- 8 b) Three provisions are included in the Settlement Agreement which address
9 regulatory lag. Fifteen months of “Post-Test Year Plant” is allowed
10 (§ 3.1) – a policy that goes a long way toward mitigating negative effects
11 related to use of a historic test year. Similarly, revisions to the
12 Environmental Improvement Surcharge (“EIS”) provide that “when APS
13 invests capital to fund any government-mandated environmental controls,
14 the EIS will recover the associated capital carrying costs, subject to [the
15 current EIS] cap ...” (Section XI). This provision also diminishes
16 regulatory lag negatives, because such investments traditionally have had
17 to await the next rate case before their costs could be recovered. The
18 potential that rates can be adjusted during the four-year stay-out due to a
19 future acquisition by APS (with ACC approval) related to certain Southern
20 California Edison generation assets (Section X) also mitigates regulatory
21 lag;

- 1 c) The 90/10 sharing provision in the Company's Power Supply Adjustor is
2 being eliminated (§ 7.3). This will align cost recovery with the actual fuel
3 and purchased power costs incurred and expended by APS; and
4 d) Finally, deferring for future recovery or refund from customers any
5 property tax changes as a result of the rate increasing or decreasing from
6 the test year level (but not changes in the assessed value of property) is a
7 modification that seeks to align cost recovery or refund with actual cost
8 levels that are incurred, rather than fixing them at a historic test year level
9 (Section XII).

10
11 **Q. WHILE THESE PROVISIONS ARE THOUGHT OF AS SETTLEMENT**
12 **AGREEMENT BENEFITS FOR THE COMPANY, DO THEY ALSO**
13 **HAVE POSITIVE CONSEQUENCES AND RATE IMPACTS FOR**
14 **CONSUMERS?**

15 A. Yes, they do. Adjustments which minimize the effects of regulatory lag, like the
16 post-test year plant inclusion, moderate customer rate increases by reducing the
17 level of expense recovery which is "postponed" to the next rate case.
18 Consequently, they smooth the size of necessary rate adjustments and mitigate the
19 need for larger, future rate increases. More important, though, because such
20 adjustments are viewed favorably by rating agencies, customers benefit from the
21 lower debt costs that stronger APS credit ratings can produce. As I pointed out in
22 my direct testimony, a positive result in this rate case, following the constructive
23

1 2009 settlement, could well produce another ratings upgrade for APS. That also
2 would provide additional downside protection for APS in these volatile economic
3 times and, accordingly, protection for its customers as well.
4

5 **Q. HAVE YOU REVIEWED THE COST OF CAPITAL SECTION OF THE**
6 **AGREEMENT AND, IF SO, CAN YOU OFFER YOUR THOUGHTS?**

7 A. Yes, I have. The authorized return on common equity ("ROE") of 10% (§ 5.2)
8 falls somewhat below recent ROE awards in other jurisdictions for vertically
9 integrated electric utilities, while the 53.94% equity component within APS'
10 capital structure (§ 5.1) is consistent with a level that should continue to allow the
11 Company to improve its financial condition and credit ratings over time.
12 Accordingly, I find those two provisions of the Settlement Agreement to be a fair
13 accommodation between the positions put forward by the parties.
14

15 CONCLUSION

16 **Q. WHAT ARE YOUR CONCLUDING THOUGHTS?**

17 A. Taken as a whole, I see a Settlement Agreement which came together through
18 give and take by all signatories and which strikes a balance *based upon the values*
19 *that the contesting parties placed on the issues in dispute*. This Commission now
20 has the opportunity to focus on the key issue – whether the Settlement Agreement
21 as a whole aligns with the public interest of the State of Arizona. Based upon my
22 25-year involvement within the regulated utility sector, I believe that the
23

1 Settlement Agreement's provisions clearly represent a good faith effort on the
2 part of contesting parties to compromise on their competing positions in a fair
3 manner and, in several instances, to produce benefits that a fully litigated case
4 rarely can achieve. I believe close Commission review should produce a
5 conclusion that the Settlement Agreement is reasonable vis-à-vis the public
6 interest and that it should be approved.
7

8 **Q. DOES THIS CONCLUDE YOUR SETTLEMENT TESTIMONY?**

9 A. Yes, it does.
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